**STATE BOARD OF EQUALIZATION**
**STAFF LEGISLATIVE BILL ANALYSIS**

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| Date Amended: | **04/04/00** | Bill No: | **SB 1556** |
| Tax: | **Sales and Use** | Author: | **Brulte, et al.** |
| Board Position: | | Related Bills: | |

## BILL SUMMARY:

This bill would provide a partial sales and use tax exemption (5 percent) for the sale or use of tangible personal property used to provide broadband services in the conduct of an Internet service business, or to upgrade cable television facilities or telecommunications facilities for the provision of advanced digital communication services or similar services.

## ANALYSIS:

Current Law:

Under current law, the sales and use tax is imposed on the sale or use of tangible personal property in this state, including sales of computer hardware and pre-written computer software. A sale of custom computer software is considered to be a service rather than a sale of tangible personal property, and therefore, is not subject to the sales or use tax.

Under existing law, a base state and local sales and use tax rate of 7 ¼ percent is imposed as noted below:

- 5 percent state tax allocated to the state's General Fund (Section 6051, 6051.3, 6201 and 6201.3).
- 1/2 percent state tax allocated to the Local Revenue Fund which is dedicated to local governments for program realignment (Section 6051.2 and 6201.2).
- 1/2 percent state tax allocated to the Local Public Safety Fund which is dedicated to local governments to fund public safety services (Sec. 35 of Article XIII of the California Constitution).
- 1 1/4 percent Bradley-Burns Uniform Local Sales and Use Tax which is allocated to cities and counties (Part 1.5, commencing with Section 7200).
- 1/8 to 1 1/4 percent Transactions and Use Tax which is allocated to special taxing jurisdictions in various counties and cities within the state (Part 1.6, commencing with Section 7252).

Proposed Law:

This bill would add Section 6379.3 to the Revenue and Taxation Code to provide a partial sales and use tax exemption (5 percent) for the sale or use of tangible personal property for use by a qualified person in the conduct of an Internet service business, or to upgrade cable television facilities, or telecommunications facilities for the provision of advanced digital communication services or similar services. This bill also provides that the exemption would not apply to the sale or use of tangible personal property used primarily in administration, general management, or marketing, or to office furniture or motor vehicles.

This bill would also define "advanced digital communications services" mean telecommunications services that rely on packetized technology and have the capability of supporting transmission speeds of at least 128 kilobits per second in both directions. Advanced digital communication services would not include data services that are not primarily based on packetized technologies, x.25-based and x.75 based packetized technology, and circuit-switched services.

This bill would also define a qualified person to mean either 1) an enterprise that includes a provider for a fee of telecommunication services that provides those services directly to the public, or 2) a subsidiary, affiliate, partner, or coventurer of a telecommunications provider as described above. A qualified person would not include a provider of telecommunications services that provides those services only to single structures including, but not limited to, a hotel, office, or apartment building.

The provisions of the bill would become operative on the first day of the calendar quarter commencing more than 90 days after the bill is enacted.

**COMMENTS:**

1. Sponsor and Purpose. According to the author's office, this bill is co-sponsored by MCI, ATT, Sprint, and GTE. The purpose of this bill is to provide a tax incentive to purchase advanced Internet-related equipment. This equipment provides the infrastructure for the Internet and will provide a needed competitive boost to accelerating the deployment of high-speed, broadband equipment in the State of California.
2. Administration. This bill would only provide a partial sales and use tax exemption (5 percent) for the sale of qualifying property. Due to the method used to report partial tax exemptions, any return containing a claimed partial tax exemption must be processed manually for the proper allocation of local taxes. The number of returns that would be affected by the proposed exemption are expected to be minor. No additional problems with administration of the proposed exemption are anticipated.

**3.** What is packet-based technology? Conventional technology captures a circuit for use of two parties communicating over the circuit. As there are pauses in the conversation, the line or circuit is empty, or wasted. Because the circuit is committed to the exclusive use of the parties, no other use can be made of those blank spaces in the circuit. Circuit technology is generally used for voice communications.

Packet technology is an alternate way of transmitting data. Packet technology takes the data, such as words, and puts them into electronic packets. A communication between two parties consists of an exchange of a series of packets. Information is broken down by the sending computer and put into packets and sent out independently. The receiving computer reassembles the packets in the proper sequence. The advantage of packet technology is that the empty spaces or pauses in a communication can be filled with other packets being transferred between other parties. Therefore, packet technology is more efficient because transmissions can be packeted and a number of simultaneous separate transmissions can be combined.

Packet technology is generally used to transfer information over the Internet. Circuit based technology is generally used for voice communications. This bill is intended to provide an exemption for the sale and use of property used to provide Internet services, which is why circuit based technology is not included in the definition of tangible personal property.

**4.** What type of property is covered by this bill? The bill provides that the exemption shall apply to sales of tangible personal property used to provide broadband services. Broadband is a transmission capable of supporting a wide range of frequencies, typically from audio up to video frequencies. It can carry multiple signals simultaneously by dividing the total capacity of the medium into multiple, independent bandwidth channels, where each channel operates only on a specific range of frequencies. The type of tangible personal property that would be used for providing broadband services would include computers, routers, hubs, software, transmission lines, and any other type of equipment that could be used to send, receive, and route data. This bill does provide that the exemption will not apply to the sale or use of tangible personal property used in administration, general management, or marketing, or to office furniture, or motor vehicles.

**5.** Free Internet service providers would not be covered by this bill. The definition of a qualified person for this bill includes a provider for a *fee* of telecommunications services. Several Internet service providers (ISP) now offer free Internet access. Rather than charging a monthly access charge to the subscriber, the subscriber must fill out a detailed application. The ISP will then sell the subscribers information to marketing groups who can then target a specific group of individuals with advertising. The subscriber also agrees to have a window on their computer open at all times that will continuously display banners (advertisements). The ISP that provides free access would not meet the definition of a qualified person under this bill and would not receive the benefit of the tax exemption.

**6.** Current technology. Most people accessing the Internet are currently using a modem to link up with an ISP. This requires the user to dial up the ISP to gain access, which can take up to 2 minutes to achieve a connection. Depending on the ISP and the number of other users that are online at the same time, it may be difficult to obtain a connection with the ISP, or the transfer of data may be very slow. One of the newest ways to access the Internet is through a Digital Subscriber Line (DSL). Generally, a DSL works over existing transmission lines, but requires special equipment to be installed on the user's computer. The advantages of DSL include much faster download speeds, good value (monthly access charge is usually not much more than the typical dial up account), and an always on connection (no need to dial into the network to gain access). The disadvantage of DSL is the lack of coverage. DSL is a distance sensitive technology that requires the user to be within a certain distance (usually about 3 miles) from the connecting office. Current coverage is limited to large populated areas.

**COST ESTIMATE:**

Because of the partial exemption, administrative costs would be incurred in computer programming, return revisions and return processing. A detailed estimate of these costs is pending.

**REVENUE ESTIMATE:**

SB 1556 would exempt from the 5% state sales and use tax the sale or use of tangible personal property purchased for use by a qualified person to be used to provide broadband services in the conduct of an Internet service business, or to upgrade cable TV facilities or telecommunications facilities for the provision of advanced digital communication services.

Background, Methodology, and Assumptions

SB 1556 defines "advanced digital communications services" as telecommunications services that rely on packetized technology and have the capability of supporting transmission speeds of at least 128 kilobits per second in both directions. The bill further defines "qualified person" as either an enterprise that includes a provider for a fee of telecommunications services that provides those services directly to the public, or to those classes of users that, without regard to the facilities used, effectively constitute the public, or a subsidiary, affiliate, partner, or coventurer of such a telecommunications provider.

The intent is to limit the exemption to just that tangible personal property used to provide broadband service by those who would provide these services directly to the public.

According to the industry, the expenditures that would be subject to the provisions of this bill amount to $700 million in the first year and $900 million annually thereafter.

Revenue Summary

The revenue impact from exempting the purchases of tangible personal property purchased for use by a qualified person to be used to provide broadband services would be as follows:

| | Revenue Effect |
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| First year (2001) | |
| State loss (5%) | $35 million |
| Annual loss after first year | |
| State loss (5%) | $45 million |

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*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.*